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Choose use Loan or Equity Capital to Achieve Optimal Capital Structure

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Abstract
The ultimate goal of financial decisions is to maximize shareholder value or maximize corporate value. In today's conditions of integration and fierce competition, businesses want to survive and develop, in addition to determining the right business strategy, managing human resources well, looking for solutions to improve the quality of life. To improve production and business efficiency, it is necessary to determine the optimal capital structure. Optimal capital structure is understood as an ideal ratio between long-term debt and total long-term capital at which a business can maximize the value of earnings per share at a low cost of capital. Best. One of the important issues for corporate financial administrators is how to build the capital structure of the business, how much equity, and how much to borrow from banks to maximize value. Enterprise, also known as building an optimal capital structure. This is a very important issue for corporate finance, because capital structure has a direct impact on corporate financial risk, return on equity, average cost of capital, and cost of capital. Enterprise value. Businesses can raise capital from many different sources to finance production and business activities. Researching and establishing the optimal capital structure in accordance with the actual situation and goals of the business based on the choice of using debt or equity is always one of the most important tasks of the company set for each business.
Therefore, the article analyzes the impact of debt and equity use on the optimal capital structure of enterprises.

Keywords: Capital Structure, Debt, Equity

1. Introduction
Capital structure depends greatly on the unique characteristics of each business such as bankruptcy, profitability, asset quality and structure, and growth opportunities.
Optimal capital structure is understood as an ideal ratio between long-term debt and total long-term capital at which a business can maximize the value of earnings per share at a low cost of capital. Best.
The optimal capital structure is the capital structure that balances risk and profit, thereby maximizing the company's stock price. Corporate financial administrators can establish an optimal capital structure based on the qualitative and quantitative factors affecting the capital structure of the enterprise.

2. Theoretical basis for the optimal capital structure of an enterprise
The capital structure of a business shows how the business uses debt (bonds or loans from banks, credit institutions) or equity (including common equity, preferred shares and profits). Retained) to finance the business activities of the enterprise. According to Stephen A. Ross, Randolph W. Westerfield and Bradford D. Jordan (1997) [3]: "The capital structure of an enterprise is a combination of the use of debt capital and equity capital in a certain ratio to financing production and business activities". According to Horne *et al* (2005) [2], "capital structure is the combination of debt and equity of an enterprise". According to Ahmad and colleagues (2012) [1], "capital structure is the proportion relationship between debt and equity in the total capital of an enterprise to finance production and business activities".
However, to achieve optimal capital structure, businesses need to consider using debt or equity capital to maximize business value. According to the traditional view: optimal capital structure is the best combination of debt and equity financing to maximize the market value of the enterprise while minimizing the average cost of capital of the enterprise. Minimizing the weighted average cost of capital (WACC) is one way to optimize for the lowest-cost financing mix. The lower the cost of capital, the greater the present value of the company's future cash flows, discounted by the WACC. Therefore, the primary goal of any corporate finance department should be to find the optimal capital structure that generates the lowest WACC and the

greatest value of the company (shareholder wealth).

In fact, points to note with optimal capital structure include:

First, the optimal capital structure is different for each industry. The characteristics of the industry in which the business operates will contribute to determining the capital structure of the business. Because there are some industries that require more use of tangible fixed assets than other industries, such as telecommunications and electronics. In short, industries that have a greater need to invest in fixed assets (such as machinery and equipment, factories, and land) are more likely to be able to use debt.

Second, capital structure changes depending on the growth cycle of the business. For businesses that are in the start-up or growth phase, the optimal capital structure is to use a lot of equity capital because at this stage, shareholders will not need dividends but they expect capital surplus in the future. As for businesses that are in a period of cash surplus, they should implement a capital structure with debt as a financial strategy to take advantage of financial leverage. Excess cash can be used to make payments. Dividends for shareholders increase, or use that cash to buy back your own shares.

3. Research methods

The article uses qualitative research methods including two basic methods: data collection, synthesis and analysis and evaluation. Based on the synthesis of data related to the advantages and disadvantages of using debt and equity capital, the article helps business financial administrators choose one of these two sources of capital or a combination. Both sources of capital are suitable for production and business conditions to maximize the value of the business.

4. Choose to use debt or equity to optimize the capital structure of the business

4.1 Advantages and disadvantages of using debt

4.1.1 Advantages of using debt

Debt is less expensive than equity because it is less risky. The required return needed to compensate debt investors is less than the required return needed to compensate equity investors, because interest payments take precedence over dividends and creditors have priority in the event of liquidation. Debt is also cheaper than equity for two reasons: First, bond rights (bondholders' rights) have priority before shareholders' rights if the business falls into bankruptcy, so bondholders are considered to have a lower risk level than shareholders, corresponding to this safety, they will receive a rate of return (which is the debt interest rate) lower than the rate of return on the company's equity. Shareholders.

Second, interest expenses are deductible before tax, reducing the income tax that businesses must pay, giving businesses the benefit of a tax shield.

Businesses with good prospects will try to raise capital using debt instead of equity, to avoid dilution and send any negative signals to the market.

4.1.2 Disadvantages of using debt

Besides the above advantages, there is a limit to the amount of debt a business must have because too much debt will increase interest payments, fluctuations in income and the risk of bankruptcy. An increase in financial risk to shareholders means they will require greater returns to compensate them, which increases WACC and reduces the market value of a business. The optimal structure involves using enough equity to minimize the risk of default taking into account the variability of the business's cash flows.

Businesses with stable cash flows can withstand much larger debt loads and will have a much higher proportion of debt in their optimal capital structure. However, if a business raises too much capital in a given period of time, the cost of debt, preferred stock, and common equity will begin to increase, and when this happens, the marginal cost of capital will also increase. Increase. In contrast, businesses with fluctuating cash flows will have little debt and a large amount of equity.

In theory, debt financing offers the lowest cost of capital due to its tax-deductibility. However, too much debt increases the financial risk to shareholders and the return on equity they require. Therefore, businesses must find the optimal point at which the marginal benefit of debt equals the marginal cost.

4.2 Advantages and disadvantages of using equity capital

4.2.1 Advantages of using equity capital

Share capital is one of the important sources of capital for businesses. When choosing this method of raising capital from shareholders, businesses will receive the following benefits:

First, businesses can start their business without the burden of debt. Most new business owners like the fact that they can use their own money and investors' money to start their business instead of having to borrow a large sum of money from a bank, financial institution or other individual. Businesses can do business and not have to worry about repaying loans.

Second, when there are risks or losses in the short term, businesses can do business without pressure from creditors.

Third, businesses can rotate capital more proactively while not being pressured by debt repayment deadlines.

The effectiveness of using equity capital is expressed through the return on equity (ROE). ROE is calculated by dividing net income by shareholders' equity. ROE is considered a measure of a business's profitability and how effectively it generates profits.

4.2.2 Disadvantages of using equity capital

Besides the above benefits, when choosing equity capital, businesses will have the following disadvantages:

First, the investors will be part-owners of the business and that part of ownership is proportional to the amount of investment they put into the business. Investors have the right to control the enterprise and all wish to share in the business profits of the enterprise.

Second, shareholders' dividends are paid from after-tax income, so it is disadvantageous for businesses.

Third, if a business issue shares to a small number of investors, it will not have to involve much paperwork. But if issuing shares widely, businesses will have to comply with a lot of procedures and paperwork.

5. Conclusion

Thus, on the basis of analyzing the advantages and disadvantages of debt and equity, businesses can consider choosing these two forms to achieve the optimal capital structure on the basis of thoroughly grasping the trade-off principle between risk and profit. In fact, businesses always have to choose which capital source to use to finance production and business activities among many different opportunities. Therefore, businesses must trade off between accepting risk and expecting to receive greater profits when choosing to use debt or equity. However, future profits are not certain, so only adventurous directors who dare to accept risks are able to gain large profits. And directors who do not want to face risks will use all long-term resources to finance long-term assets, and all short-term resources to finance short-term assets. At that time, profitability and solvency were both at an average level.

The above principle is also widely applied when businesses choose a funding structure for a specific project. Determining the financing ratio of what percentage of equity, what percentage of bank loans or bond issuance is also determined based on the trade-off between risk and profit. Using equity is safer and has higher costs, while using debt will affect solvency but has lower costs.

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